

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

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FISCAL IMPACT STATEMENT

LS 8128

BILL NUMBER: HB 1868

DATE PREPARED: Feb 12, 1999

BILL AMENDED: Feb 10, 1999

SUBJECT: Internal Revenue Code Update and other Tax Provisions.

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FUNDS AFFECTED: ☒ **GENERAL**
☒ **DEDICATED**
FEDERAL

IMPACT: State & Local

Summary of Legislation: (Amended) (A) This bill updates the references to the Internal Revenue Code.

(B) The bill provides that ordinances to adopt, increase, rescind, or repeal local income taxes, innkeepers' taxes, food and beverage taxes, and certain other local taxes must be adopted after January 1 and before April 1 of a year. It provides that certified copies of these ordinances must be sent by certified mail to the commissioner of the department of state revenue not more than ten days after adoption. It also provides that these ordinances take effect July 1 of the year in which they are adopted. It provides that, for purposes of local innkeepers' taxes, local food and beverage taxes, and certain other local taxes, if the department of state revenue determines after December 31, 1999, that a person's estimated monthly tax liability for the current year or average monthly tax liability for the preceding year exceeds \$5,000, the person must pay the monthly tax due by electronic funds transfer or by delivering in person or by overnight courier a payment by cashier's check, certified check, or money order.

(C) This bill changes the date on which a county treasurer remits gross income tax receipts from the sale or transfer of an interest in real estate to the department of state revenue from the 15th to the 20th day of the month following the end of a quarterly period.

(D) The bill provides that Roth IRAs and educational IRAs are not subject to levy or sale on execution or any other final process from a court for a judgment founded upon an express or implied contract or tort claim. (Current law provides that traditional IRAs are not subject to levy or sale on execution or any other final process from a court for a judgment founded upon an express or implied contract or tort claim.)

(E) It makes changes regarding the professional sports development and convention development tax area law applicable outside Marion County to require that at least one facility be used by a professional sports franchise, that facilities for convention or tourism related events serve national or regional markets, and that an agreement exist regarding tax distributions if there is a mix of facility owners.

(F) This bill extends the use tax exemption for tangible personal property that is destined out of state to property that is delivered from within Indiana. (Current law provides that only the use of property delivered into Indiana is exempt.)

(G) It changes the definition of qualifying child for the earned income tax deduction.

(H) It also changes the definition of dependent for the medical care savings account deduction.

(I) It requires the Department of State Revenue to compile business income data.

(J) The bill allows the Department of State Revenue to enter into an agreement with the Secretary of the Treasury to offset federal tax refunds for Indiana income taxes owed.

(K) It requires state gross retail and use taxes to be paid monthly but reports to be filed quarterly, except under certain circumstances. It also changes reporting and payment requirements under the sales and use tax law. It changes the minimum sales and use tax due from \$10,000 to \$5,000 under the electronic fund transfer requirements.

(L) The bill also combines the motor carrier certification process for property and passenger carriers under the property carrier law.

(M) It removes vehicle registration information from the income tax return.

(N) It also eliminates the requirement that voter registration forms be included in income tax returns that are mailed.

The bill also corrects internal references.

Effective Date: (Revised) January 1, 1999 (Retroactive); Upon Passage; July 1, 1999; January 1, 2000.

Explanation of State Expenditures: (Revised) (I) The Department of State Revenue will be required to gather business income data for use by the Legislative Services Agency and State Budget Agency through and electronic database format for use in business income taxation studies. This can be accomplished within the Department's existing budget.

(K) The requirement that remitters of sales and use tax pay monthly, but only file reports on a quarterly basis is designed to create administrative savings for the Department and taxpayers. The threshold for filing, by remitters of sales and use tax, by electronic fund transfer is also reduced to \$5,000 (from \$10,000) per month. This will increase the number of remitters filing by electronic fund transfer.

(L) Motor carrier certification law is clarified to include private carriers of property and passengers.

(M) The provision which removes the requirement of obtaining the vehicle identification number of vehicles owned by taxpayers is eliminated to be consistent with current practice.

(N) The elimination of the requirement that voter registration forms will be mailed with tax returns will result in some administrative savings. Voter registration forms will be supplied with returns supplied to locations such as banks and libraries.

Explanation of State Revenues: (Revised) (A) This bill updates the references to the Internal Revenue Code (IRC) in the current statute to reflect changes made in the IRC before January 1, 1999. The current statute references the IRC effective January 1, 1998. During 1998, the Internal Revenue Service Restructuring and Reform Act of 1998 (HR 2676) was enacted which made a number of federal tax changes that could affect Indiana adjusted gross income calculations (AGI) and individual income tax revenue. The Tax and Trade Relief Extension Act of 1998 (Division J of HR 4328, The Omnibus Consolidated and Emergency Supplemental Appropriations Act,) P.L. 105-277 (1998) also contains a few provisions which will affect individual AGI.

Information from the Federal Tax Administrators (FTA) and the Joint Committee on Taxation (JCT) have been reviewed in order to estimate the impact of various provisions in this Act. The following provisions have been identified which will have an impact on state revenue due to changes in tax administration or Indiana adjusted gross income (AGI) with the change in the IRC reference date of January 1, 1999. The estimated tax impacts cited below are based on information from the JCT.

Refund Offset: HR 2676 allows states to participate in the federal refund offset program to recapture income tax debts. This program will now cover state and local income tax delinquencies administered by the state. State delinquencies submitted for the federal refund offset will only be granted after other eligible debt owed by the taxpayer for federal taxes, overdue child support, or student loans are satisfied. The state must notify the taxpayer via certified mail that the debt is going to be referred for federal offset. The program will apply to refunds issued after December 31, 1999. As of October 6, 1998, state tax delinquencies for individual income taxes equaled \$3.5 M. Not all of this debt would be collectible because specific conditions must be met for participation in the offset program. This provision will increase income tax collections by an indeterminable amount beginning in FY 2001.

Roth IRA: Beginning in the 2005 tax year, the minimum required distributions of IRAs are not included in the definition of AGI for the purpose of determining eligibility to convert an IRA to a Roth IRA. Under the present law, distributions are includible in gross income in the year of distribution. The Taxpayer Relief Act of 1997 allowed taxpayers to convert deductible or nondeductible IRAs into a Roth IRA but eligibility was capped for taxpayers with an AGI under \$100,000. Distributions were also part of the calculation of AGI. In essence the change created in HR 2676 raises the income eligibility for taxpayers to make use of the Roth IRAs. This change could potentially increase state and federal revenue on a one-time basis for tax year 2005 or FY 2006.

Employer Deduction for Vacation and Severance Pay: HR 2676 includes a provision that employer deductions made for vacation and severance pay may not be made until they are actually received by the employee. This provision is intended to overrule the *Schmidt Banking* Tax Court decision which allowed the employer a deduction for accrued vacation and severance pay liabilities since they purchased an irrevocable letter of credit. The Court held that the letter of credit constituted payment of vacation and severance pay since it was purchased within the 2 ½ month period so that the payment was not considered deferred compensation and was allowable as a deduction for the employer. HR 2676 clarified that many arrangements, in addition to the letter of credit approach used in *Schmidt Banking*, do not constitute actual receipt by employees.

Since vacation and severance pay deductions will not be eligible until these payments are actually received by the employee, the JCT anticipates an increase in the AGI of employers. This provision is effective for taxable years beginning in 1998.

Estimated state impact: + \$2.1 M in FY 99, + \$2.6 M in FY 2000, + \$1.6 M in FY 2001

Meal Deduction: HR 2676 allows employers to take an income tax deduction for meals furnished to employees at a place of business if the meals are provided for the convenience of the employer and are furnished to more than one-half of the employees. Employees do not have to include the value of the meals as income. This provision will decrease employers adjusted gross income by the amount of the allowable deduction and have a minimal impact on revenue collections.

Mark-to-Market Receivables: Dealers in nonfinancial goods and services will not be able to elect “mark-to-market” accounting rules to deduct receivables as a loss. This provision will increase the AGI of these taxpayers.

Estimated state impact: + \$670,000 in FY 99, + \$1.24 M in FY 2000, + \$1.02 M in FY 2001

Income Averaging for Farmers: The three year income averaging provision for individuals who have taxable income from the trade or business of farming was made permanent. This provision was set to expire December 31, 2000.

Estimated state impact: Minimal loss beginning in FY 2001.

Net Operating Loss Carryback Period for Farmers: Currently taxpayers engaged in farming business were allowed to carry back a net operating loss (the amount by which business deductions exceeded business gross income) for two years and carry forward the loss for 20 years to offset taxable income in those years. The carry back provision was extended to a five year period effective for tax years beginning after December 31, 1997.

Estimated state impact: Minimal Loss beginning in FY 99.

Self-Employed Health Insurance Deduction: This deduction was recently increased in the 1996 Health Insurance Portability Act, Public Law 104-191, the Taxpayer Relief Act of 1997 (H.R. 2014) and the Tax and Trade Relief Extension Act of 1998 (Division J of HR 4328, The Omnibus Consolidated and Emergency Supplemental Appropriations Act,) P.L. 105-277 (1998). The percentage of the federal deductions are outlined in the following table.

Tax Year	'96 Health Insurance Portability Act	1997 Taxpayer Relief Act	P.L. 105-277 1998
1999	45%	NC	60%
2000	45%	50%	60%
2001	45%	50%	60%
2002	45%	60%	70%
2003	50%	80%	100%
2004	60%	80%	100%
2005	70%	80%	100%
2006	80%	90%	100%
2007	80%	100%	100%

Estimated state impact: (\$500,000) in FY 99, (\$900,000) in FY 2000, (\$700,000) in FY 2001

State Volume Limits on Private Activity Tax-Exempt Bonds: Current law restricts the volume of tax-

exempt private activity bonds that States and local governments may issue to the greater of \$50 per resident of the state or \$150 M. This volume limit is increase to the greater of \$55 per resident or \$165 M in CY 2003, \$60 per resident or \$180 M in CY 2004, \$65 per resident or \$195 M in CY 2005 and \$70 per resident or \$210 M in CY 2006.

Estimated state impact: Revenue loss beginning in FY 2003 and years after.

Regulated Invested Companies (RICs) and Real Estate Investment Trusts (REITs): Effective for distributions made after May 21, 1998, any amount of which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to a 80-percent corporate owner is now includible as income for the recipient corporation. This amount is treated as a dividend received from the RIC or REIT. If banks operating in Indiana were using this mechanism, there could be a minimal increase in financial institutions tax revenue beginning in FY 99.

Tax Treatment of Prizes and Awards: The principle of constructive receipt is eliminated for the payment of prizes and awards if the winner elects an option of receiving an annuity instead of receiving a lump-sum distribution. Currently the taxpayer must pay taxes on the entire prize even if they elect to receive an annuity option. This change will allow the taxpayer to pay taxes only on the amount received annually and will spread the amount of taxes paid over the payment of the annuity instead of the first year. Depending on the election of the taxpayer for large prizes, this provision will spread out the payment of taxes versus the state receiving all the taxes in the first year. This could result in the reduction in revenue beginning in FY 2000.

A summary of the above provisions follows (in millions):

Provision	FY 99	FY 2000	FY 2001
Refund Offset			positive
Roth IRA (effects FY 2006)			
Employer vacation & severance pay	2.1	2.6	1.6
Meal deductions	Minimal Loss	Minimal Loss	Minimal Loss
Mark-to-Market	.7	1.2	1.0
Income averaging for Farmers			Minimal Loss
NOL Carryback for Farmers	Minimal Loss	Minimal Loss	Minimal Loss
Self-employed health insurance deduct.	(.5)	(.9)	(.7)
Vol. Limits-Tax-Exempt bonds (FY 2003)			
RICs & REITS liquidating distributions	Potential Incr	Potential Incr	Potential Incr
Tax treatment of Prizes & Awards	Minimal Loss	Minimal Loss	Minimal Loss
Net Impact (millions)	2.30	2.90	1.90

The Internal Revenue Service Restructuring and Reform Act of 1998 (HR 2676) also made a number of federal tax changes that could affect Indiana state tax revenue even without an update to the Indiana Code. However, taxpayers would have to recalculate income and capital gains for purposes of determining Indiana adjusted gross income based on the 1998 Internal Revenue Code if Indiana does not update to the 1999 Internal Revenue Code. A number of the changes regarding capital gains which could affect Indiana taxable income are described below.

Capital Gains: The Taxpayer Relief Act of 1997 cut the tax rates of capital gains for investments held for at least 18 months. The rates were reduced from 28% to 20% and to 10% for taxpayers in the 15% tax bracket. This change created three different holding periods and three different maximum tax rates. The current law also taxes capital gains on investments held from 12 to 18 months at a maximum rate of 28%, and capital gains on investments held for less than 12 months are taxed at the ordinary income tax rate of the individual.

HR2676-1998 lowers the holding period from 18 months to 12 months for investments to be eligible for the 20% capital gains tax rate. This change simplifies the capital gains tax structure and creates only two, instead of three, holding periods and rate structures. Federal estimates from the JCT suggest that this change will increase income generated from capital gains of investments sold after the 12-month holding period.

The Taxpayer Relief Act of 1997 also allowed exclusions of capital gains on the sale of a principal residence up to \$250,000 for a single taxpayer and \$500,000 for married couples regardless of whether the gains are rolled over into another residence. However the taxpayer must have lived in the residence for at least two years. A partial exclusion was allowed if the taxpayer owned the residence for less than two years if they were forced to move due to a job transfer. This exclusion was based on how long the homeowners actually lived in the house.

HR 2676 provides a “technical correction” to clarify the intent of the partial exclusion. The Internal Revenue Service had interpreted the pro-rated basis to be applied to the actual gain made on the sale of the home. HR 2676 clarifies that the pro-rated basis is applied to the amount of the exclusion. For example, if a taxpayer lived in a home for one year and made a gain of \$100,000, the 50% pro-rated exclusion would apply to the limit of \$250,000 (\$125,000) versus 50% of the gain made on the home (\$50,000). In this case the taxpayer would be able to exclude the full amount of the gain since the pro-rated exclusion would be \$125,000 versus \$50,000 as originally interpreted by the IRS.

Estimated state impact: + \$1.56 M in FY 99, + \$520,000 in FY 2000

(B) This bill will result in more taxpayers remitting their tax liabilities through electronic fund transfer. Beginning January 1, 2000, the threshold for remitting the Sales and Use Tax, the Adjusted Gross Income Tax, and the Gasoline Tax by electronic fund transfer is lowered from an average monthly liability of \$10,000 to \$5,000. For the Gross Income Tax and the Financial Institutions Tax, the same threshold change is made for average quarterly liabilities. This should result in the more efficient collection of these taxes.

Beginning January 1, 2000, for Innkeepers’s Taxes and Food and Beverage Taxes collected by the Department, the threshold is established at an average monthly liability \$5,000 for the requirement that persons collecting those taxes remit by electronic funds transfer. Currently those taxes are not required to be remitted by electronic funds transfer.

(C) This bill allows county treasurers to remit gross income tax receipts from the sale or transfer of an interest in real estate to the Department of State Revenue on the 20th day of the month following the end of a quarterly period. Current law requires the remittance to be on the 15th day of the month. This will result in a minimal loss of interest earnings from the five day delay of receiving these tax receipts but it will bring the remittance dates in conformity with other tax filing dates.

(D) No Fiscal Impact.

(E) See Local Revenues.

(F) The bill clarifies that the use tax exemption for tangible personal property processed in Indiana by commercial printers and transported out of Indiana for sole use outside of Indiana applies to property that is delivered into Indiana from sources within or outside the state. Any impact would be negligible.

(G) This bill expands the earned income deduction to cover all dependents who qualify under the Internal Revenue Code (IRC). The current deduction only covers dependents under the age of 18 years old. The IRC reference for this deduction will also cover dependents who are students under the age of 24. This could result in a minimal increase in the use of the deduction.

(H) For purposes of the employee medical care savings account plans, the definition of dependent is changed to be consistent with the Internal Revenue Code. The change expands the definition except that mentally or physically incapacitated children over the age of 18 will now not be included.

(J) The bill allows the Department to enter an agreement with the Internal Revenue Service for purposes of collecting state income tax obligations through a refund offset. This could assist the Department in the collection of delinquent liabilities.

Explanation of Local Expenditures:

Explanation of Local Revenues: (Revised) (A) Those counties that have a local option income tax may see a net increase in revenue due to the above provisions.

(B) See State Revenues.

(E) The bill clarifies the conditions under which a city or county may establish a professional sports and convention development (PSCDA) area. Under current law, a PSCDA may include only facilities owned by a city, a county, a school corporation, a local capital improvement board (only in counties not containing a consolidated city), a civic center's board of directors in South Bend and Mishawaka, or the Building Authority in Gary. A PSCDA may only contain a facility that is owned by one of these entities and is used either by a professional sports franchise **or** for tourism and convention events.

This bill would require all PSCDAs to contain a professional sports facility. This bill also provides that any facility in a PSCDA other than a professional sports arena must be used "principally" for convention and tourism related events. In addition, the bill clarifies that if a PSCDA that contains multiple facilities, these facilities may have different owners provided they are included in the list of eligible owners provided in the paragraph above. If multiple owners exist, this bill would further require the parties involved to establish an agreement specifying the distribution of tax revenues collected for the PSCDA fund.

Revenue generated inside a PSCDA through the gross retail tax and the individual AGI tax is deposited into a special fund for capital improvement within the area until the annual limit on captured state taxes is reached. The amount may not exceed an amount equal to \$5 multiplied by the number of residents of the city or county. Food and beverage taxes and local option income taxes earned in PSCDAs are also captured for capital improvement, and there is no limit on the amount of these local taxes that may be captured.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: County Treasurers; Counties with a local option income tax.

Information Sources: Federation of Tax Administrators; Joint Committee on Taxation; Department of State Revenue, Tom Conley, 232-2107.